

Ninth Circuit rejects securities claims, viewing confidential witness allegations with skepticism

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On April 19, 2024, the U.S. Court of Appeals for the Ninth Circuit affirmed the dismissal of a putative securities class action. The plaintiff's complaint relied heavily on allegations attributed to former employee confidential witnesses. The Ninth Circuit's opinion conducts a lucid, critical analysis of the complaint, concluding that the allegations attributable to confidential witnesses were insufficient to meet the "heightened and demanding" pleading requirements for securities claims.

According to the [panel opinion](#), J2 Global, Inc. (J2) is a company that uses an "acquisition model to grow its business," having acquired 186 businesses for a total of \$3 billion since its founding in 1995. (Op. at 5.) In the litigation, a putative stockholder alleged that J2 and certain of its personnel sought to use acquisitions to enrich executives and directors, and used consolidated accounting to "shroud[] underperforming acquisitions and investments in questionable ventures." (Op. at 5.)

To state a claim for securities fraud under Section 10(b) of the Securities Exchange Act of 1934 (the Exchange Act) and Rule 10b-5 of the Exchange Act's implementing regulations, a plaintiff must plead a material misrepresentation or omission in connection with the purchase or sale of a security, scienter, reliance, economic harm and loss causation.

Pleading scienter requires pleading facts, with particularity, showing the following:

"defendants acted with the intent to deceive or with deliberate recklessness as to the possibility of misleading investors... . Deliberate recklessness is a higher standard than mere recklessness and requires more than a motive to commit fraud. Instead, deliberate recklessness represents an extreme departure from the standards of ordinary care ... which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it." (Op. at 9 (citations and internal quotation marks omitted).)

In an effort to meet this standard, the plaintiff included in his complaint allegations attributed to two former J2 employees. According to the complaint, one former employee—a regional managing director—claimed that J2's Vice President of Corporate Development was compensated based on the number of deals that he suggested that eventually closed, rather than on the quality of the companies acquired. This former employee claimed that the Vice President's incentives led to "shoddy due diligence, overpayment for acquisitions" and poor efforts at proper integration. (Op. at 10.)

The other former employee—the head of human resources for more than a decade—echoed some of the same contentions and further claimed that the same Vice President of Corporate Development pushed to acquire a company of which he and his girlfriend were the only employees, and did so in part because acquiring the company would allow his girlfriend to get a visa to live in the United States. (Op. at 11.) The former employee claimed these facts were known to J2 higher-ups.

The district court twice dismissed the plaintiff's complaint on the ground that he failed to adequately plead scienter.

In the Ninth Circuit, in a decision authored by Circuit Judge M. Margaret McKeown and joined by Circuit Judges Consuelo M. Callahan and Kenneth K. Lee, the panel confirmed that courts must parse confidential witness allegations closely at the motion to dismiss stage.

The panel explained that to establish scienter using confidential witnesses, the witnesses must be described with sufficient particularity to establish their reliability and personal knowledge. The court held that most of the confidential former employees' statements "fail to establish reliability or personal knowledge, or simply amount to criticisms of J2's management practices and compensation structures." (Op. at 11.) The panel indicated that "[w]hat is missing are credible allegations of an intent to defraud investors." (Op. at 13.) The panel also found that some of what the complaint alleged about some of the acquisitions described in the complaint was based not on what a former employee necessarily had personally heard, but rather on "incomplete report[ing]" about the relevant events.

Although the former employees claimed that senior executives must have known more about the performance of individual business units than the company disclosed, the panel found that the allegations did not succeed in showing scienter either: "[I]nconsistent statements from former employees do not demonstrate that the individual defendants actually knew the underlying data of each of their acquisitions with the requisite accuracy to report detailed financials for each." (Op. at 15.)

Judge McKeown wrote: "Dissatisfaction with a company's strategy, management, and approach to accounting, coupled with a stock drop, make for interesting reading but not an actionable securities fraud claim." (Op. at 4.)

The panel also found that although the district court had not reached the issue, its decision should be affirmed because the plaintiff had failed to plead loss causation as well. To plead loss causation, a plaintiff must plausibly allege that a corrective disclosure revealed the truth the defendant had concealed, and that the disclosure led to a decline in the company's stock price. The plaintiff relied on two short-seller reports about J2—reports whose issuance preceded stock price drops. The panel found that one of these reports was untethered to the plaintiff's allegations of corporate misconduct, and that the other report was based entirely on public information. (Op. at 21-23.) The court found that, as a result, neither could properly be deemed a corrective disclosure that would support a claim for liability.

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